



**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Basic Financial Statements and Single Audit Reports

Year ended June 30, 2002

(With Independent Auditors' Reports Thereon)

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Basic Financial Statements and Single Audit Reports

Year ended June 30, 2002

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SECTION I – INTRODUCTION



P.O. Box 4150
Honolulu, HI 96812-4150

March 24, 2003

To the Director of the
Department of Business,
Economic Development, and Tourism
State of Hawaii:

We have completed the audit of the basic financial statements of the Department of Business, Economic Development, and Tourism, State of Hawaii (Department), as of and for the year ended June 30, 2002. We have also audited the Department's compliance with requirements applicable to its major federal financial assistance programs. We submit herein our reports on the Department's basic financial statements and federal financial assistance programs.

The audit objectives and scope of the financial audit were as follows:

AUDIT OBJECTIVES

1. To provide a basis for an opinion on the fairness of the Department's basic financial statements.
2. To determine whether the Department complied with those provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes), which could have a direct and material effect on the determination of financial statement amounts.
3. To evaluate the Department's system of internal control over financing reporting.
4. To determine whether the Department has complied with applicable laws, regulations, contracts, and grants that could have a direct and material effect on each major federal financial assistance program.
5. To evaluate internal control over compliance with requirements of regulations, contracts, and grants that could have a direct and material effect on each major federal financial assistance program.
6. To determine the current status of the audit recommendations included in the prior year's independent auditors' report on compliance and on internal control over financial reporting.

SCOPE OF AUDIT

1. We performed an audit of the Department's basic financial statements as of and for the year ended June 30, 2002 in accordance with auditing standards generally accepted in the United States of America, as adopted by the American Institute of Certified Public Accountants, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.



To the Director of the
Department of Business,
Economic Development, and Tourism
State of Hawaii
March 24, 2003

2. As part of the audit of the Department's basic financial statements, we performed tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes) and procurement rules, directives, and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. We also evaluated the Department's system of internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements.
3. We performed an audit of the Department's federal financial assistance programs for the year ended June 30, 2002 in accordance with auditing standards generally accepted in the United States of America, as adopted by the American Institute of Certified Public Accountants, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, certain provisions of OMB Circular A-133 and the applicable sections described in the *OMB's Circular A-133 Compliance Supplement*.

ORGANIZATION OF REPORT

Our report is organized into four sections as follows:

1. Section I, entitled "Introduction," describes the objectives and scope of our financial audit and the organization and contents of this report.
2. Section II, entitled "Basic Financial Statements," contains the Department's basic financial statements and footnotes for the year ended June 30, 2002, and our report thereon.
3. Section III, entitled "Compliance and Internal Control Over Financial Reporting," contains our report on the Department's compliance and internal control over financial reporting based upon our audit of the Department's basic financial statements.
4. Section IV, entitled "Compliance and Internal Control Over Federal Awards," contains our report on the Department's compliance and internal control over federal awards in accordance with OMB Circular A-133, a schedule of expenditures of federal awards, and a schedule of findings and questioned costs.

We would like to take this opportunity to express our appreciation to the personnel of the Department of Business, Economic Development, and Tourism for the cooperation and assistance extended to us during our audit. We will be pleased to discuss any questions that you or your associates may have regarding our recommendations.

Very truly yours,

KPMG LLP

SECTION II – BASIC FINANCIAL STATEMENTS



P.O. Box 4150
Honolulu, HI 96812-4150

Independent Auditors' Report

To the Director of the
Department of Business,
Economic Development, and Tourism
State of Hawaii:

We have audited the accompanying financial statements of the governmental activities and each major fund of the Department of Business, Economic Development, and Tourism, State of Hawaii (Department), as of and for the year ended June 30, 2002, which collectively comprise the Department's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Department's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As discussed in note 1, the financial statements of the Department are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and major fund information of the State that are attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2002, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of the Department as of June 30, 2002, and the respective changes in financial position and the respective budgetary comparison for the general and economic development special revenue funds for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As described in note 1 to the basic financial statements, the Department adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, and Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, effective July 1, 2001.



In accordance with *Government Auditing Standards*, we have also issued a report dated November 8, 2002 on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The Department has not presented management's discussion and analysis that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the basic financial statements.

KPMG LLP

November 8, 2002

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Statement of Net Assets

June 30, 2002

Assets:

Cash in state treasury (note 4)	\$	53,790,386	
Cash in bank (note 4)		106,028	
Petty cash		56,050	
Investment in venture capital limited partnerships, at cost (note 2)		6,942,000	
Receivables:			
Accounts, net (note 5)		317,141	
Loans, net (note 5)		4,735,431	
Interest		40,136	
Due from grantor		163,811	
Due from Hawaii Convention Center		282,445	
Capital assets (note 7):			
Land and construction in progress	\$	152,202,511	
Other capital assets, net		<u>196,753,422</u>	
Capital assets, net			<u>348,955,933</u>
Total assets			<u>415,389,361</u>

Liabilities:

Vouchers payable		3,545,085	
Accrued payroll		496,650	
Due to other state agencies (note 6)		2,829,000	
Due to State General Fund		56,050	
Deferred revenues		1,146,202	
Accrued vacation payable (note 8):			
Due within one year		593,604	
Due in more than one year		<u>1,663,445</u>	
Total liabilities			<u>10,330,036</u>

Net assets:

Invested in capital assets		348,955,933	
Unrestricted		<u>56,103,392</u>	
Total net assets	\$		<u><u>405,059,325</u></u>

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Statement of Activities

Year ended June 30, 2002

	Program expenses (notes 6, 9, 10, and 11)		Program revenues		Net expense and changes in net assets
		Charges for services	Operating grants and contributions		
Governmental activities:					
Hawaii Tourism Authority	\$ 70,879,472	\$ —	\$ —	\$ 70,879,472	
Hawaii Convention Center	19,866,143	—	—	19,866,143	
Business services and development	13,311,109	357,434	6,598,542	6,355,133	
General Support for Economic Development	4,764,052	14,327	1,381,434	3,368,291	
Hawaii Strategic Development Corporation	3,956,615	—	—	3,956,615	
High Technology Development Corporation	3,768,441	1,448,392	—	2,320,049	
Energy development and management	3,737,771	88,595	2,220,900	1,428,276	
Natural Energy Laboratory of Hawaii Authority	2,821,744	1,441,857	—	1,379,887	
Office of Planning	2,257,444	—	—	2,257,444	
Foreign-Trade Zone	1,524,810	1,450,832	—	73,978	
Aloha Tower Development Corporation	1,482,285	333,333	—	1,148,952	
Economic planning and research for economic development	1,313,588	—	—	1,313,588	
Land Use Commission	518,007	—	—	518,007	
Hawaii Tourism Office	34,386	—	—	34,386	
Clean Hawaii Center	3,231	—	3,231	—	
Total governmental activities	\$ 130,239,098	\$ 5,134,770	\$ 10,204,107	114,900,221	
General revenues:					
Transient accommodations tax				59,743,471	
State allotted appropriations, net of reversions and lapses				26,408,648	
Lapsed appropriations related to previous years				(732,616)	
Interest				2,381,887	
Nonimposed employee fringe benefits (notes 9 and 10)				1,468,272	
Other				567,190	
Total general revenues				89,836,852	
Transfers				(99,898)	
Change in net assets				(25,163,267)	
Net assets at July 1, 2001, as restated (note 13)				430,222,592	
Net assets at June 30, 2002				\$ 405,059,325	

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Balance Sheet – Governmental Funds

June 30, 2002

Assets	General	Economic Development Special Revenue	Capital Projects	Total Governmental Funds
Cash in state treasury (note 4)	\$ 4,220,542	\$ 44,169,825	\$ 5,400,019	\$ 53,790,386
Cash in bank (note 4)	—	106,028	—	106,028
Petty cash	34,000	22,050	—	56,050
Investment in venture capital limited partnerships, at cost (note 2)	—	6,942,000	—	6,942,000
Receivables:				
Accounts, net (note 5)	—	317,141	—	317,141
Loans, net (note 5)	—	4,735,431	—	4,735,431
Interest	—	40,136	—	40,136
Due from grantor	—	163,811	—	163,811
Due from Hawaii Convention Center	282,445	—	—	282,445
Total assets	<u>\$ 4,536,987</u>	<u>\$ 56,496,422</u>	<u>\$ 5,400,019</u>	<u>\$ 66,433,428</u>
Liabilities and Fund Balances				
Liabilities:				
Vouchers payable	\$ 600,787	\$ 2,088,275	\$ 856,023	\$ 3,545,085
Accrued payroll	304,305	192,345	—	496,650
Due to other state agencies (note 6)	—	2,829,000	—	2,829,000
Due to State General Fund	34,000	22,050	—	56,050
Deferred revenues	—	1,146,202	—	1,146,202
Total liabilities	<u>939,092</u>	<u>6,277,872</u>	<u>856,023</u>	<u>8,072,987</u>
Fund balances (deficit):				
Reserved for encumbrances	3,667,196	14,914,634	3,367,301	21,949,131
Reserved for capital projects	—	—	1,176,695	1,176,695
Reserved for other purposes	—	88,105	—	88,105
Unreserved	(69,301)	35,215,811	—	35,146,510
Total fund balances	<u>3,597,895</u>	<u>50,218,550</u>	<u>4,543,996</u>	<u>58,360,441</u>
Total liabilities and fund balances	<u>\$ 4,536,987</u>	<u>\$ 56,496,422</u>	<u>\$ 5,400,019</u>	
Amounts reported in the statement of net assets are different because (see note 1):				
Capital assets used in governmental activities are not financial resources and therefore are not reported in the funds				348,955,933
Long-term liabilities are not due and payable in the current period and therefore are not reported in the funds				<u>(2,257,049)</u>
Net assets of governmental activities				<u>\$ 405,059,325</u>

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds

Year ended June 30, 2002

	<u>General</u>	<u>Economic Development Special Revenue</u>	<u>Capital Projects</u>	<u>Total Governmental Funds</u>
Revenues:				
Transient accommodations tax	\$ —	\$ 59,743,471	\$ —	\$ 59,743,471
State allotted appropriations, net of reversions and lapses	25,125,648	—	1,283,000	26,408,648
Intergovernmental	—	10,204,107	—	10,204,107
Charges for current services	—	5,134,770	—	5,134,770
Interest	—	2,381,887	—	2,381,887
Nonimposed employee fringe benefits (notes 9 and 10)	1,468,272	—	—	1,468,272
Other	—	567,190	—	567,190
Total revenues	<u>26,593,920</u>	<u>78,031,425</u>	<u>1,283,000</u>	<u>105,908,345</u>
Expenditures (notes 6, 9, 10, and 11):				
Hawaii Tourism Authority	—	70,731,211	—	70,731,211
Hawaii Convention Center	12,749,069	—	—	12,749,069
Business services and development	3,934,426	8,737,336	—	12,671,762
Hawaii Strategic Development Corporation	—	3,924,598	—	3,924,598
General support for economic development	2,466,433	1,365,563	—	3,831,996
Energy development and management	1,250,724	2,231,539	—	3,482,263
High Technology Development Corporation	1,337,503	1,590,722	—	2,928,225
Natural Energy Laboratory of Hawaii Authority	1,114,939	1,549,840	—	2,664,779
Office of Planning	1,965,716	—	—	1,965,716
Aloha Tower Development Corporation	—	1,440,294	—	1,440,294
Foreign-Trade Zone	—	1,357,519	—	1,357,519
Economic planning and research for economic development	1,147,280	—	—	1,147,280
Land Use Commission	446,798	—	—	446,798
Hawaii Tourism Office	34,386	—	—	34,386
Clean Hawaii Center	—	3,231	—	3,231
Capital outlays	—	—	11,253,502	11,253,502
Total expenditures	<u>26,447,274</u>	<u>92,931,853</u>	<u>11,253,502</u>	<u>130,632,629</u>
Excess (deficiency) of revenues over expenditures	<u>146,646</u>	<u>(14,900,428)</u>	<u>(9,970,502)</u>	<u>(24,724,284)</u>
Other financing sources (uses):				
Operating transfers in	—	136,200	—	136,200
Operating transfers out	(136,200)	—	—	(136,200)
Operating transfer to the State Department of Accounting and General Services	(33,300)	(66,598)	—	(99,898)
Lapsed appropriations related to previous years	(459,747)	—	(272,869)	(732,616)
Total other financing sources (uses), net	<u>(629,247)</u>	<u>69,602</u>	<u>(272,869)</u>	<u>(832,514)</u>
Deficiency of revenues and other financing sources over expenditures and other financing uses	<u>(482,601)</u>	<u>(14,830,826)</u>	<u>(10,243,371)</u>	<u>(25,556,798)</u>
Fund balances, July 1, 2001	4,080,496	65,049,376	14,787,367	
Fund balances, June 30, 2002	<u>\$ 3,597,895</u>	<u>\$ 50,218,550</u>	<u>\$ 4,543,996</u>	

Amounts reported in the statement of net assets are different because (see note 1):

Governmental funds report capital outlays as expenditures; however, in the statement of activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the current period

2,663,046

Some expenses reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds

(2,269,515)

Change in net assets

\$ (25,163,267)

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Statement of Fiduciary Net Assets

Fiduciary Fund

June 30, 2002

	<u>Agency Funds</u>
Assets:	
Cash in state treasury (note 4)	\$ 203,295
Cash in bank (note 4)	<u>41,948</u>
Total assets	245,243
Liabilities:	
Deposits payable	<u>245,243</u>
Net assets	\$ <u><u> </u></u>

See accompanying notes to basic financial statements.

DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM

STATE OF HAWAII

Statement of Revenues and Expenditures – Budget and Actual
(Budgetary Basis) – General and Economic Development Special Revenue Funds

Year ended June 30, 2002

	General Fund				Economic Development Special Revenue Fund			
	Original Budget	Final Budget	Actual (Budgetary Basis)	Variance Favorable (Unfavorable)	Original Budget	Final Budget	Actual (Budgetary Basis)	Variance Favorable (Unfavorable)
Revenues:								
State allotted appropriations, net of reversions and lapses	\$ 26,917,523	\$ 25,506,722	\$ 25,125,648	\$ (381,074)	\$ —	\$ —	\$ —	\$ —
Other	—	—	—	—	132,491,425	92,857,587	67,245,581	(25,612,006)
Total revenues	<u>26,917,523</u>	<u>25,506,722</u>	<u>25,125,648</u>	<u>(381,074)</u>	<u>132,491,425</u>	<u>92,857,587</u>	<u>67,245,581</u>	<u>(25,612,006)</u>
Expenditures:								
Hawaii Tourism Authority	—	—	—	—	110,782,012	71,057,164	70,762,537	294,627
Hawaii Convention Center	15,000,000	13,027,147	12,972,378	54,769	—	—	—	—
Commerce and industry	3,138,039	3,212,526	3,102,419	110,107	8,185,569	8,202,447	3,830,509	4,371,938
Energy development and management	1,394,333	1,416,546	1,279,227	137,319	100,000	100,000	—	100,000
General support for economic development	1,931,253	2,211,861	2,195,627	16,234	—	—	—	—
High Technology Development Corporation	1,499,177	1,509,023	1,457,033	51,990	3,461,442	3,481,759	1,911,220	1,570,539
Natural Energy Laboratory of Hawaii Authority	959,447	958,860	952,683	6,177	1,981,000	1,981,000	1,292,801	688,199
Office of Planning	1,662,219	1,782,159	1,761,791	20,368	—	—	—	—
Aloha Tower Development Corporation	—	—	—	—	1,503,552	1,518,296	357,458	1,160,838
Economic planning and research for economic development	916,162	979,362	972,009	7,353	—	—	—	—
Foreign-Trade Zone	—	—	—	—	1,973,377	2,008,498	1,542,120	466,378
Land Use Commission	416,893	409,238	399,181	10,057	—	—	—	—
Hawaii Strategic Development Corporation	—	—	—	—	4,104,473	4,108,423	3,919,832	188,591
Clean Hawaii Center	—	—	—	—	400,000	400,000	—	400,000
Total expenditures	<u>26,917,523</u>	<u>25,506,722</u>	<u>25,092,348</u>	<u>414,374</u>	<u>132,491,425</u>	<u>92,857,587</u>	<u>83,616,477</u>	<u>9,241,110</u>
Excess (deficiency) of revenues over expenditures	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 33,300</u>	<u>\$ 33,300</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (16,370,896)</u>	<u>\$ (16,370,896)</u>

See accompanying notes to basic financial statements.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2002

(1) Financial Statement Presentation

(a) Reporting Entity

The Department of Business, Economic Development, and Tourism (Department) is a department of the State of Hawaii (State). The Department's basic financial statements present the financial position and changes in financial position of only that portion of the governmental activities and major fund information of the State that are attributable to the transactions of the Department. The State Comptroller maintains the central accounts for all State funds and publishes comprehensive financial statements for the State annually, which include the Department's financial activities.

The objective of the Department is to make broad policy determinations with respect to economic development within the State and to stimulate research (through research and demonstration projects) in industrial and economic development that offer the most immediate promise to expand the State's economy. In addition, the Department endeavors to gain an understanding of those functions and activities of other governmental agencies and of private agencies that are related to the field of economic development. The Department also encourages initiative and creative thinking in harmony with the objectives of the Department.

The State has defined its reporting entity in accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*. This statement establishes standards for defining and reporting on the financial reporting entity. The basic criterion for including a potential component unit within the reporting entity is financial accountability. Other criteria include legal standing and fiscal dependency.

The Department's basic financial statements consist of the financial activities of the Department and certain other agencies of the State, that are administratively attached to the Department. The following agencies are blended component units of the State and are included in the Department's basic financial statements:

Aloha Tower Development Corporation
Hawaii Strategic Development Corporation
Hawaii Tourism Authority
High Technology Development Corporation
Land Use Commission
Natural Energy Laboratory of Hawaii Authority
Office of Planning

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2002

The Department's basic financial statements do not include the financial statements of the Hawaii Community Development Authority (HCDA) and the Housing and Community Development Corporation of Hawaii (HCDCH).

Complete financial statements for HCDA and HCDCH may be obtained at the HCDA and HCDCH administrative offices.

The basic financial statements of the Department have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP), as applicable to governmental units. The GASB is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The GASB issued Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, and Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. These pronouncements establish new financial reporting requirements and a new financial reporting model for state and local governments. The Department adopted these pronouncements effective July 1, 2001. The following describes the more significant changes for the Department.

(b) Government-Wide Financial Statements

The reporting model includes a statement of net assets and a statement of activities prepared using full accrual accounting for all of the government's activities. This approach includes not just current assets and liabilities (such as cash and accounts payable) but also capital assets and long-term liabilities (such as buildings and accrued vacation payable). Accrual accounting also reports all of the revenues and cost of providing services each year, not just those received or paid in the current year or soon thereafter.

Statement of Net Assets

The statement of net assets is designed to display the financial position of the Department. The Department reports all capital assets in the government-wide statement of net assets and reports depreciation expense – the cost of “using up” capital assets – in the statement of activities. Net assets are classified into three categories – (1) invested in capital assets; (2) restricted; and (3) unrestricted. The Department did not have any restricted net assets at June 30, 2002.

Statement of Activities

The new government-wide statement of activities reports expenses and revenues in a format that focuses on the cost of each of the Department's functions. The expense of individual functions is compared to the revenues generated directly by the function (for instance, through user charges or intergovernmental grants).

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Notes to Basic Financial Statements

June 30, 2002

(c) *Government-Wide and Fund Accounting*

The basic financial statements include both government-wide (based on the Department as a whole) and fund financial statements. While the previous reporting model emphasized fund types (the total of all funds of a particular type), in the new reporting model the focus is on either the Department as a whole or major individual funds (within the fund financial statements). The government-wide statement of net assets is reflected on a full accrual, economic resource basis, which incorporates long-term assets and receivables as well as long-term obligations. The Department generally first uses restricted assets for expenses incurred for which both restricted and unrestricted assets are available.

The government-wide statement of activities reflects both the gross and net cost per functional category (Hawaii Tourism Authority, Hawaii Convention Center, Business Services and Development, etc.) which is otherwise being supported by general government revenues (transient accommodations tax, state allotted appropriations, interest, nonimposed employee fringe benefits, etc). The statement of activities reduces gross expenses (including depreciation) by related program revenues. Program revenues must be directly associated with the function. The Department does not allocate indirect expenses.

The Department's fiduciary funds are presented in the fund financial statements. Since by definition these assets are being held for the benefit of a third party and cannot be used to address activities or obligations of the government, these funds are not incorporated into the government-wide statements.

The Department uses funds to report on its financial position and the results of its operations. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain departmental functions or activities.

A fund is a separate accounting entity with a self-balancing set of accounts. The Department uses two fund type categories: governmental and fiduciary. Each category, in turn, is divided into separate "fund types":

Governmental Funds – the Department has the following major funds:

General Fund – is the general operating fund of the Department. It is used to account for all financial resources except those required to be accounted for in another fund.

Economic Development Special Revenue Fund – is used to account for programs related to the development and promotion of industry and international commerce, energy development and management, economic research and analysis, and the utilization of resources.

Capital Projects Fund – is used to account for financial resources to be used for the acquisition and construction of the NELHA On Shore Distribution System, Oceanic Institute Aquatic Animal Hatchery, Volcano Art Center, and other capital assets.

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Fiduciary Funds – used to account for assets held on behalf of outside parties. Agency funds are generally used to account for assets that the Department holds on behalf of others as their agent.

(2) Summary of Significant Accounting Policies

(a) *Financial Statement Presentation, Basis of Accounting, and Measurement Focus*

The accounting policies of the Department conform to GAAP applicable to state and local governments as prescribed by GASB through its statements and interpretations. The government-wide statement of net assets and statement of activities are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation of these activities are included on the statement of net assets.

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and current liabilities generally are included on the balance sheet. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses) in net current assets.

The modified accrual basis of accounting is used by all governmental fund types and trust funds. Under the modified accrual basis of accounting, revenues such as interest are recognized when susceptible to accrual (i.e., when they become both measurable and available to finance operations of the fiscal year or liquidate liabilities existing at year-end).

Measurable means that the amount of the transaction can be determined. Available means that the amount is collected in the current fiscal year or soon enough after year-end to liquidate liabilities existing at the end of the fiscal year. The Department considers receivables collected within 60 days after year-end to be available and recognizes them as revenues of the current year. Expenditures are recorded when the related fund liability is incurred.

The Department reports deferred revenues on its statement of net assets and balance sheet. Deferred revenues arise when both the “measurable” and “available” criteria for recognition are not met in the current period. Deferred revenues also arise when the Department receives resources before it has a legal claim to them, as when grant monies are received prior to the incurrence of qualifying expenditures. In subsequent periods, when both revenue recognition criteria are met, or when the Department has a legal claim to the resources, the liability for the deferred revenue is removed from the statement of net assets and balance sheet and revenue is recognized.

Encumbrances represent commitments related to unperformed contracts for goods or services. Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of resources are recorded to reserve that portion of the applicable appropriation, is utilized in the governmental funds. Encumbrances outstanding at year-end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will generally be honored during the subsequent fiscal year.

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(b) *Investments*

Investments in venture capital limited partnerships are carried at cost, which amounted to \$6,942,000 at June 30, 2002. The fair value of these investments approximated \$7,055,517 at June 30, 2002. Fair value of the Department's limited partnership interests is based on the fair value of the underlying securities owned by the limited partnerships obtained from international and national security exchanges or are based on estimated values. The Department has outstanding commitments to fund these venture capital funds of \$4,358,000 at June 30, 2002.

(c) *Capital Assets*

Capital assets are not capitalized in the funds used to acquire or construct them. Instead, capital acquisition and construction are reflected as expenditures in governmental funds, and the related assets are reported in the statement of net assets. Capital assets acquired by purchase are recorded at cost. Donated fixed assets are valued at the estimated fair market value on the date received. Maintenance, repairs, minor replacements, renewals, and betterments are charged to operations as incurred. Major replacements, renewals, and betterments are capitalized. Capital assets are defined as assets with an initial individual cost of \$5,000 or more and are depreciated on the straight-line method over the estimated useful lives of the respective assets (land improvements – 15 years, buildings and improvements – 30 years, and furniture, fixtures, and equipment – 5 to 7 years). Depreciation is recorded on capital assets on the government-wide statement of activities.

(d) *Accrued Vacation Payable and Sick Leave*

Department employees' accrued vacation payable is expected to be liquidated with future expendable resources and is therefore accrued in the statement of net assets. Sick leave is not convertible to pay upon termination of employment and is recorded as an expenditure when taken.

(e) *Program Revenues*

The Department charges various program fees that include office space and facility rental fees, ground rent fees, storage service fees, maintenance fees, and facility management fees.

Federal grant and assistance awards made on the basis of entitlement periods are recorded as revenue when available and entitlement occurs. All other federal reimbursement-type grants are recorded as receivables and revenues when the related expenditures are incurred.

(f) *Transient Accommodations Tax*

In accordance with Sections 201B-11 and 237D-6.5, Hawaii Revised Statutes (HRS), a portion of the funding for the Department's economic development special revenue fund operations is derived from 37.9% of the transient accommodations tax. The transient accommodations tax is assessed at a rate of 7.25% on the gross rental or gross rental proceeds derived from providing transient accommodations.

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(g) *Nonexchange Transactions*

Effective July 1, 2000, the Department adopted GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, which requires the Department to record grant revenue only when all eligibility requirements have been met and amounts are available.

(h) *Intrafund and Interfund Transactions*

Transfers of financial resources within the same fund are eliminated. Transfers from funds receiving revenues to funds through which the resources are to be expended are recorded as operating transfers. Nonrecurring or nonroutine transfers of equity between funds are recorded as residual equity transfers.

(i) *Use of Estimates*

The preparation of basic financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, as well as disclosure of contingent assets and liabilities at the date of the basic financial statements, and the reported amounts of revenues, expenditures, and other financing sources and uses during the reporting period. Actual results could differ from those estimates.

(3) *Budgeting and Budgetary Control*

The budget of the Department is a detailed operating plan identifying estimated costs and results in relation to estimated revenues. The budget includes (1) the programs, services, and activities to be provided during the fiscal year, (2) the estimated revenues available to finance the operating plan, and (3) the estimated spending requirements of the operating plan. The budget represents a process through which policy decisions are made, implemented, and controlled.

Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated periodically during the fiscal year. Amounts reflected as budgeted revenues in the statement of revenues and expenditures – budget and actual (budgetary basis) – general and special revenue funds are those estimates as compiled and reviewed by the Department. Budgeted expenditures are derived primarily from the General Appropriations Act of 2001 (Act 259, Session Laws of Hawaii of 2001), as amended by the Supplemental Appropriations Act of 2002 (Act 177, Session Laws of Hawaii of 2002), and from other authorizations contained in the State Constitution, HRS, and other specific appropriations acts in various Session Laws of Hawaii. Federal financial assistance program revenues are not included in the statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds.

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All expenditures of these appropriated funds are made pursuant to the appropriations in the fiscal 2001 – 2003 biennial budget, as amended by subsequent supplemental appropriations.

The general and economic development special revenue funds have legally appropriated annual budgets. Capital projects fund appropriated budgets are for projects that may extend over several fiscal years.

The final legally adopted budget in the accompanying statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds represents the original appropriations, transfers, and other legally authorized legislative and executive changes.

The legal level of budgetary control is maintained at the appropriation line item level by department, program, and source of funds as established in the appropriations act. The Governor is authorized to transfer appropriations between programs within the same department and source of funds; however, transfers of appropriations between departments generally require legislative authorization. Records and reports reflecting the detail level of control are maintained by and are available at the Department. During the fiscal year ended June 30, 2002, there were no expenditures in excess of appropriations at the legal level of budgetary control.

To the extent not expended or encumbered, general and economic development special revenue funds appropriations generally lapse at the end of the fiscal year for which the appropriations are made. The State Legislature specifies the lapse dates and any other contingencies which may terminate the authorizations for other appropriations.

Budgets adopted by the State Legislature for the general and economic development special revenue funds are presented in the accompanying statement of revenues and expenditures – budget and actual (budgetary basis) – general and economic development special revenue funds. The Department's annual budget is prepared on the modified accrual basis of accounting with several differences from the preparation of the statement of revenues, expenditures, and changes in fund balances, principally related to (1) encumbrance of purchase orders and contract obligations, (2) accrued revenues and expenditures, and (3) unbudgeted programs (federal award programs). The first two differences represent departures from GAAP.

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A reconciliation of the budgetary to GAAP basis operating results for the fiscal year ended June 30, 2002 follows:

	<u>General</u>	<u>Economic Development Special Revenue</u>	
Excess (deficiency) of revenues over expenditures — actual (budgetary basis)	\$ 33,300	\$ (16,370,896)	
Reserved for encumbrances at year-end	3,667,196	6,771,389	*
Reserved for encumbrances at beginning of year	(4,367,476)	(5,364,785)	*
Net accrued revenues and expenditures	217,679	38,767	*
Unbudgeted revenues and other financing sources net of expenditures and other financing uses	<u>(33,300)</u>	<u>94,699</u>	
Deficiency of revenues and other financing sources over expenditures and other financing uses — GAAP basis	<u>\$ (482,601)</u>	<u>\$ (14,830,826)</u>	

* Amount reflects the balances related to budgeted programs only.

(4) Cash

The State Director of Finance is responsible for the safekeeping of all monies paid into the state treasury. The State Director of Finance pools and invests any monies of the State, which in the Director's judgment, are in excess of amounts necessary for meeting the immediate requirements of the State. Legally authorized investments include obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit and repurchase agreements with federally-insured financial institutions.

The State established a policy whereby all unrestricted and certain restricted cash is invested in the State's investment pool. Cash accounts that participate in the investment pool accrue interest based on the average weighted cash balances of each account. The Department records the pooled assets as cash in state treasury.

For demand or checking accounts and time certificates of deposit, the State requires that the depository banks pledge collateral based on daily available bank balances. The use of daily available bank balances to determine collateral requirements results in the available balances being under-collateralized at various times during the fiscal year. All securities pledged as collateral are held either by the state treasury or by the State's fiscal agents in the name of the State.

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Information regarding the carrying amount and corresponding bank balances of the cash (which includes the Department's cash in state treasury) and collateralization of the cash balances is included in the comprehensive annual financial report of the State.

The carrying value of the Department's cash in bank balance of \$106,028 equals the bank balance and was uncollateralized at June 30, 2002. Such balance primarily represents the Department's bank accounts maintained for out-of-state operations and security deposits held for the Foreign-Trade Zone Division and the High Technology Development Corporation.

(5) Accounts and Loan Receivable

At June 30, 2002, accounts and loans receivable consisted of the following:

	<u>Accounts Receivable</u>	<u>Loans Receivable</u>
Foreign-Trade Zone Division	\$ 240,869	\$ —
Natural Energy Laboratory of Hawaii Authority	274,329	—
High Technology Development Corporation	303,800	—
Financial Assistance Branch:		
Hawaii Capital Loan Program	—	8,801,213
Hawaii Community-Based Development Loan Program	—	332,356
Hawaii Innovation Development Loan Program	—	265,302
Hawaii Disaster Commercial Loan Program	—	50,695
	<u>818,998</u>	<u>9,449,566</u>
Less allowance for doubtful accounts	<u>(501,857)</u>	<u>(4,714,135)</u>
Accounts and loans receivable, net	<u>\$ 317,141</u>	<u>\$ 4,735,431</u>

(6) Due to Other State Agencies

The Aloha Tower Development Corporation (ATDC) is a State agency established under HRS Chapter 206J, primarily to redevelop the Aloha Tower complex. The complex encompasses Piers 5 to 23 of Honolulu Harbor. In September 1993, the State Department of Transportation – Harbors Division (Harbors) entered into a lease with the ATDC (ATDC lease) which grants the leasehold interest in portions of the Aloha Tower complex to the ATDC. The ATDC is required annually to reimburse Harbors for any losses in revenues during the term of the lease caused by any action of the ATDC or the developer and to provide replacement facilities for maritime activities at no cost to Harbors.

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In September 1993, the ATDC subleased lands surrounded by Piers 8 and 9 and a portion of land surrounded by Pier 10 to a developer and entered into a capital improvements, maintenance, operations, and securities agreement (Operations Agreement) with the developer and Harbors. Harbors continues to operate the harbor facilities at Piers 8, 9, and 10. The lease between the ATDC and the developer requires the developer to construct, at the developer's cost, various facilities as designated in the developer's proposal and to reimburse Harbors for all losses in revenues and increased expenses which may be incurred by Harbors. The ATDC, Harbors, and the developer agreed that in lieu of reimbursing Harbors for losses in revenues during the construction period, the developer would perform certain work to repair the structure of Piers 8 through 11, the cost of which would otherwise be incurred by Harbors. The developer offset the maximum allowable cost of repair of \$1,100,000 against its obligation to Harbors for losses in revenues.

As of June 30, 2002, the first phase of the Aloha Tower complex development has been completed.

Pursuant to this Operations Agreement, the developer is current on amounts owed to the ATDC as of June 30, 2002. Pursuant to the ATDC lease, the ATDC owes Harbors approximately \$2,829,000 as of June 30, 2002. This amount is reflected in the economic development special revenue fund in the Department's basic financial statements.

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June 30, 2002

(7) Capital Assets

Changes in capital assets during the fiscal year ended June 30, 2002 were as follows:

	Restated Balance July 1, 2001 (note 12)	Additions	Deductions	Balance June 30, 2002
Capital assets not being depreciated:				
Land	\$ 134,446,508	\$ —	\$ —	\$ 134,446,508
Construction in progress	6,502,501	11,253,502	—	17,756,003
Total capital assets not being depreciated	140,949,009	11,253,502	—	152,202,511
Other capital assets:				
Land improvements	311,128	—	—	311,128
Buildings and improvements	250,533,745	—	—	250,533,745
Equipment	2,963,415	66,794	35,809	2,994,400
Total other capital assets	253,808,288	66,794	35,809	253,839,273
Less accumulated depreciation for:				
Land improvements	176,306	20,742	—	197,048
Buildings and improvements	46,039,280	8,350,870	—	54,390,150
Furniture, fixtures, and equipment	2,236,358	285,638	23,343	2,498,653
Total accumulated depreciation	48,451,944	8,657,250	23,343	57,085,851
Other capital assets, net	205,356,344	(8,590,456)	12,466	196,753,422
Total capital assets, net	\$ 346,305,353	\$ 2,663,046	\$ 12,466	\$ 348,955,933

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The accumulated depreciation balances at July 1, 2001 were restated to record accumulated depreciation in accordance with the adoption of GASB Statement No. 34. The gross cost balances at July 1, 2001 were also restated to reflect an increase in the Department's capitalization threshold from \$1,000 to \$5,000. Balances as of July 1, 2001 were restated as follows.

	<u>Balance July 1, 2001</u>	<u>Restatement</u>	<u>Restated balance July 1, 2001</u>
Land	\$ 127,765,894	\$ 6,680,614	\$ 134,446,508
Construction in progress	—	6,502,501	6,502,501
Land improvements	—	311,128	311,128
Buildings and improvements	245,342,520	5,191,225	250,533,745
Furniture, fixtures, and equipment	10,428,781	(7,465,366)	2,963,415
Subtotal	383,537,195	11,220,102	394,757,297
Accumulated depreciation	—	(48,451,944)	(48,451,944)
Totals	<u>\$ 383,537,195</u>	<u>\$ (37,231,842)</u>	<u>\$ 346,305,353</u>

Depreciation expense was charged to functions of the Department as follows:

Hawaii Convention Center	\$ 7,055,014
Business Services and Development	240,701
General Support for Economic Development	423,363
High Technology Development Corporation	760,704
Energy Development and Management	824
Natural Energy Laboratory of Hawaii Authority	68,086
Office of Planning	2,992
Foreign-Trade Zone	105,566
Total depreciation expense	<u>\$ 8,657,250</u>

(8) Accrued Vacation

Changes in accrued vacation payable during the fiscal year ended June 30, 2002 were as follows:

Balance, July 1, 2001	\$ 2,186,682
Net increase in accrued vacation payable	70,367
Balance, June 30, 2002	<u>\$ 2,257,049</u>

**DEPARTMENT OF BUSINESS,
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(9) Retirement Benefits

(a) *Employees' Retirement System of the State of Hawaii*

All eligible employees of the State and counties, including employees of the Department, are required by HRS Chapter 88 to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS is governed by a Board of Trustees. All contributions, benefits, and eligibility requirements are established by HRS Chapter 88, and can be amended by legislative action. The ERS issues a comprehensive annual financial report that is available to the public. That report may be obtained by writing to the ERS at 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to add a new noncontributory option for members of the ERS who are also covered under Social Security. Police officers, firefighters, judges, elected officials, and persons employed in positions not covered by Social Security are precluded from the noncontributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively.

Both options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date is based on the three highest paid years of service, excluding the vacation payment.

Most covered employees of the contributory option are required to contribute 7.8% of their salary. Police officers, firefighters, investigators of the departments of the County Prosecuting Attorney and the Attorney General, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2% of their salary. The funding method used to calculate the total employer contribution requirement is the entry age normal actuarial cost method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded actuarial liability over the remaining period of 19 years from July 1, 1997.

The contribution by the Department for the fiscal year ended June 30, 1999 was approximately \$614,000, at the rate of 5.78%, of annual covered payroll. The Department contributed 100% of its required contributions for that year. Changes in salary growth assumptions and investment earnings pursuant to Act 100, Session Laws of Hawaii of 1999, resulted in no required contribution for the fiscal years ended June 30, 2002, 2001, and 2000.

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June 30, 2002

(b) *Post-Retirement Health Care and Life Insurance Benefits*

In addition to providing pension benefits, the State, pursuant to HRS Chapter 87, provides certain health care and life insurance benefits to all qualified employees. For employees hired before July 1, 1996, the State pays the entire monthly health care premium for employees retiring with 10 or more years of credited service, and 50% of the monthly premium for employees retiring with fewer than 10 years of credited service. For employees hired after June 30, 1996, and who retire with fewer than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the State pays 75% of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the State pays the entire health care premium. There are currently approximately 22,100 state retirants receiving such benefits. Free life insurance coverage for retirants and free dental coverage for dependents under age 19 are also available. Retirants covered by the medical portion of Medicare are eligible to receive a reimbursement of the basic medical coverage premium. Contributions are financed on a pay-as-you-go basis.

The Department's contribution for post-retirement health care and life insurance benefits for the fiscal year ended June 30, 2002 was approximately \$661,000. A substantial portion of this amount is included in the nonimposed fringe benefits amount (note 10).

(10) Nonimposed Employee Fringe Benefits

Payroll fringe benefit costs of employees of the Department funded by state appropriations (general fund) are assumed by the State and are not charged to the Department's operating funds. These costs, totaling approximately \$1,468,272 for the fiscal year ended June 30, 2002, have been reported as revenues and expenditures of the Department's general fund.

Payroll fringe benefit costs related to federally-funded salaries are not assumed by the State and are recorded as expenditures in the Department's economic development special revenue fund.

(11) Fund Balance Deficit

The general fund had a deficit in its unreserved fund balance at June 30, 2002 of \$69,301. The deficit resulted from recognition of expenditures under GAAP in 2002 and will be funded with 2003 state allotted appropriations.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2002

(12) Commitments and Contingencies

(a) Leases

The Department leases office facilities and equipment under various operating leases expiring through 2006. Future minimum lease commitments of noncancelable operating leases as of June 30, 2002 were as follows:

Fiscal year ending June 30:	
2003	\$ 161,300
2004	130,900
2005	113,400
2006	63,000
2007	500
	<hr/>
	\$ 469,100
	<hr/>

The Department's rental expenditures for the fiscal year ended June 30, 2002 were approximately \$99,000.

(b) Accumulated Sick Leave

Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit, but may be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the ERS. At June 30, 2002, accumulated sick leave approximately \$6,995,000.

(c) Deferred Compensation Plan

The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all state employees, permits employees to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

All plan assets are held in a trust fund to protect them from claims of general creditors. The State has no responsibility for loss due to the investment or failure of investment of funds and assets in the plan, but does have the duty of due care that would be required of an ordinary prudent investor.

**DEPARTMENT OF BUSINESS,
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Notes to Basic Financial Statements

June 30, 2002

(d) Risk Management

GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, establishes accounting and financial reporting standards for risk financing and insurance related activities of state governmental entities and requires the recordation of a liability for risk financing and insurance related losses if it is determined that a loss has been incurred and the amount can be reasonably estimated. The State retains various risks and insures certain excess layers with commercial insurance companies. Settled claims have not exceeded the coverage provided by commercial insurance companies in any of the past three fiscal years.

The State has an insurance policy with a variety of insurers in a variety of layers for property coverage. The deductible is \$250,000 per occurrence. The deductible for windstorm coverage is 3% of loss subject to a \$250,000 per occurrence minimum. The limit of loss per occurrence is \$25,000,000. This policy includes earthquake and flood coverage whose limit of loss per occurrence is \$25,000,000 with a deductible of 3% of loss subject to the \$250,000 deductible.

Claims under \$10,000 are handled by the risk management office of the State Department of Accounting and General Services. All other claims are handled by the State Department of the Attorney General. The State has personal injury and property damage liability, including automobile and public errors and omissions, insurance policy in force with a \$3,000,000 deductible per occurrence. The annual aggregate per occurrence is \$28,000,000.

The State generally self-insures its automobile no fault and workers' compensation losses. Automobile losses are administered by third-party administrators. The State administers its workers' compensation losses. A liability for workers' compensation and general liability claims is established if information indicates that a loss has been incurred as of June 30, 2002 and the amount of the loss can be reasonably estimated. The liability also includes an estimate for amounts incurred but not reported. The estimated losses will be paid from legislative appropriations of the State General Fund and not by the Department.

(e) Litigation

From time to time the Department is named as a defendant in various legal proceedings. Although the Department and its counsel are unable to express opinions as to the outcome of the litigation, it is their opinion that any potential liability arising therefrom will not have a material adverse effect on the financial position of the Department because judgments, if any, against the Department are judgments against the State and would be paid by legislative appropriations of the State General Fund and not by the Department.

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June 30, 2002

(13) Accounting Changes and Restatements

During fiscal year 2002, the Department adopted GASB Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*. The Department also raised the capitalization threshold for capital assets from \$1,000 to \$5,000.

The accumulated depreciation balances at July 1, 2001 were restated to record accumulated depreciation in accordance with the adoption of GASB Statement No. 34. The gross cost balances at July 1, 2001 were also restated to reflect an increase in the Department’s capitalization threshold from \$1,000 to \$5,000.

The following table shows beginning net assets restated for the effects of implementation of GASB Statement No. 34 and change in accounting policy.

Fund balance as previously reported at July 1, 2001	\$ 83,917,239
GASB Statement No. 34 and accounting policy adjustments:	
Net capital assets (note 7)	<u>346,305,353</u>
Net assets as of July 1, 2001, as restated	<u><u>\$ 430,222,592</u></u>

***SECTION III – COMPLIANCE AND INTERNAL CONTROL
OVER FINANCIAL REPORTING***



P.O. Box 4150
Honolulu, HI 96812-4150

**Report on Compliance and on Internal Control over Financial Reporting
Based on an Audit of Financial Statements Performed in Accordance
with *Government Auditing Standards***

To the Director of the
Department of Business,
Economic Development, and Tourism
State of Hawaii:

We have audited the basic financial statements of the Department of Business, Economic Development, and Tourism, State of Hawaii (Department), as of and for the year ended June 30, 2002, and have issued our report thereon dated November 8, 2002. The Department adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, GASB Statement No. 37, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments: Omnibus*, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, and Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, effective July 1, 2001. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Department’s basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D, Hawaii Revised Statutes) and procurement rules, directives, and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and questioned costs as Findings 02-01 through 02-04.



Internal Control over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on internal control over financial reporting. However, we noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the basic financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as Findings 02-01 through 02-04.

A material weakness is a condition in which the design or operation of one or more internal control components does not reduce to a relative low level the risk that misstatements in amounts that would be material in relation to the basic financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

This report is intended solely for the information and use of the Department's management and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 8, 2002

***SECTION IV – COMPLIANCE AND INTERNAL CONTROL
OVER FEDERAL AWARDS***



P.O. Box 4150
Honolulu, HI 96812-4150

**Report on Compliance with Requirements
Applicable to Each Major Program and on
Internal Control over Compliance in Accordance with
OMB Circular A-133**

To the Director of the
Department of Business,
Economic Development, and Tourism
State of Hawaii:

Compliance

We have audited the compliance of the Department of Business, Economic Development, and Tourism, State of Hawaii (Department), with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2002. The Department's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Department's management. Our responsibility is to express an opinion on the Department's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Department's compliance with those requirements and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Department's compliance with those requirements.

In our opinion, the Department complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2002. However, the results of our auditing procedures disclosed an instance of noncompliance with those requirements, which is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as Finding 02-05.



Internal Control over Compliance

The management of the Department is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Department's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

We noted a certain matter involving internal control over compliance and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over compliance that, in our judgment, could adversely affect the Department's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable condition is described in the accompanying schedule of findings and questioned costs as Finding 02-05.

A material weakness is a condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control over compliance would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition described above is not a material weakness.

Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of the Department as of and for the year ended June 30, 2002, and have issued our report thereon dated November 8, 2002. The Department adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, and Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, effective July 1, 2001. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the Department's management and federal awarding agencies and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 8, 2002

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Schedule of Expenditures of Federal Awards

Year ended June 30, 2002

<u>Federal Grantor/Pass-Through Grantor/Program Title</u>	<u>CFDA Number</u>	<u>Grant Number</u>	<u>Federal Program Award Amount</u>	<u>Federal Expenditures</u>
RESEARCH AND DEVELOPMENT CLUSTER				
DEPARTMENT OF DEFENSE				
Research and Technology Development:				
National Defense Center of Excellence for Research in Ocean Sciences	12.910	MDA972-97-2-0001	\$ 31,707,564	\$ 6,532,163 *
Hawaii Electric Vehicle Demonstration Project		MDA972-95-2-0009	13,077,479	749,334 *
Total Department of Defense – Research and Development Cluster				7,281,497
DEPARTMENT OF TRANSPORTATION				
Research and Technology Development:				
Hawaii Electric Vehicle Demonstration Project	DTRS56-99-T-0017	NA	3,223,129	1,069,982 *
Total Research and Development Cluster				8,351,479
OTHER PROGRAMS				
DEPARTMENT OF COMMERCE				
Coastal Zone Management Administration Awards:				
Hawaii Coastal Zone Management Program	11.419	NA17OZ1121	1,620,000	904,395
		NA07OZ0115	1,156,000	246,885
		NA07OZ0186	225,000	96,165
		NA87OZ0233	1,014,000	7,607
		NA97OZ0161	1,121,000	214,262
Subtotal CFDA 11.419				1,469,314
Telecommunications and Information Infrastructure Assistance				
Program:				
Telecommunications and Information Infrastructure Assistance				
Program	11.552	15-50-95110	176,705	425
Total Department of Commerce				1,469,739

**DEPARTMENT OF BUSINESS,
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Schedule of Expenditures of Federal Awards

Year ended June 30, 2002

Federal Grantor/Pass-Through Grantor/Program Title	CFDA Number	Grant Number	Federal Program Award Amount	Federal Expenditures
OTHER PROGRAMS (continued)				
DEPARTMENT OF DEFENSE				
Community Economic Adjustment Planning Assistance:				
Military Base Reuse Studies and Community Planning Assistance	12.607	CL9354-00-05	\$ 226,400	\$ 36,644
Total Department of Defense – Other Programs				36,644
ENVIRONMENTAL PROTECTION AGENCY				
Solid Waste Management Assistance:				
EPA Jobs Through Recycling Program	66.808	X999817-01	236,000	19,351
Buy Recycled in Hawaii Workshops and Jobs through Recycling		X999297-01-1	100,000	3,231
Subtotal CFDA 66.808				22,582
Brownfield Pilots Cooperative Agreements:				
Brownfields Economic Redevelopment Hawaii Assessment				
Demonstration Pilot	66.811	BP-98966301	200,000	40,077
Surveys, Studies, and Investigations:				
Greenhouse Gas Reduction Strategy	N/A	CX822845-01-3	104,867	4,264
Total Environmental Protection Agency				66,923
DEPARTMENT OF ENERGY				
State Energy Program:				
Formula Grant	81.041	DE-FG51-00R021040	271,000	239,652
Advanced Building Technologies	81.119	DE-FG51-97R020759	50,000	4,232
Building Guide		DE-FG51-97R020881	255,000	23,029
Clean Cities		DE-FG51-97R020881	50,000	20,992
Rebuild America 1		DE-FG51-97R020881	108,000	24,000
Rebuild America 2		DE-FG51-98R020976	100,000	35,955

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Schedule of Expenditures of Federal Awards

Year ended June 30, 2002

Federal Grantor/Pass-Through Grantor/Program Title	CFDA Number	Grant Number	Federal Program Award Amount	Federal Expenditures
OTHER PROGRAMS (continued)				
DEPARTMENT OF ENERGY				
State Energy Program, continued:				
Cooling Climates		DE-FG51-98R021191	\$ 190,000	\$ 7,281
Commercial Guidelines		DE-FG51-99R021082	200,000	124,183
Rebuild America 3		DE-FG51-99R021083	115,000	68,455
Remote Renewables		DE-FG51-99R021084	37,616	8,441
Rebuild America 4		DE-FG51-01R021285	170,000	6,885
Distributed Energy		DE-FG51-01R021287	100,000	2,654
Remote Solar for Essential Services		DE-FG51-98R020978	131,000	112,092
Subtotal CFDA 81.119				438,199
A Financial Assistance Program for State and Municipal Demonstration of Light and Heavy Duty Alternative Fuel Vehicles:				
Demonstration of Light and Heavy Duty Alternative Fuel Vehicles	81.111	DE-FG07-97ID13501	144,200	43,805
Conservative Research and Development:				
Conservative Research and Development	81.086	DE-FG49-95R900041	169,632	4,254
Energy Efficiency and Renewable Energy Information Dissemination, Outreach, Training, and Technical Analysis Assistance:				
Bioenergy Program Support 1	81.117	DE-FC51-01R028604	30,000	16,003
SEP Initiatives		DE-FC51-01R028603	6,500	6,500
Interconnection Workshop		DE-FC51-01R028602	10,000	9,997
Support for Renewable Center		DE-FC51-01R028601	10,000	7,065
Wind Energy Support		DE-FC51-02R028605	10,000	2,330
Subtotal CFDA 81.117				41,895
Regional Biomass Energy Program:				
Bioenergy Program Support 2	81.079	DE-FC51-02R021318	15,000	3,500
Total Department of Energy				771,305

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Schedule of Expenditures of Federal Awards

Year ended June 30, 2002

Federal Grantor/Pass-Through Grantor/Program Title	CFDA Number	Grant Number	Federal Program Award Amount	Federal Expenditures
<i>OTHER PROGRAMS (continued)</i>				
FEDERAL EMERGENCY MANAGEMENT AGENCY				
Hazard Mitigation Grant:				
Emergency Generator Survey Phase I	83.548	FEMA-961-DR-HI	\$ 45,611	\$ <u>30,000</u>
U.S. DEPARTMENT OF THE INTERIOR				
Geological Survey – Research and Data Acquisition Hawaii				
Framework Demonstration Project	15.808	1434-HQ-97-AG-01875	65,000	<u>5,000</u>
Total Expenditures of Federal Awards				\$ <u><u>10,731,090</u></u>

(*) Denotes major federal program as defined by OMB Circular A-133.

See accompanying notes to schedule of expenditures of federal awards and independent auditors' report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with OMB Circular A-133.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Notes to Schedule of Expenditures of Federal Awards
Year ended June 30, 2002

(1) Basis of Presentation

The Department's basic financial statements are prepared in conformity with accounting principles generally accepted in the United States of America, as described in the notes to the basic financial statements. The accompanying schedule of expenditures of federal awards includes the federal grant activity of the Department and is presented on the cash basis of accounting, which is the same basis of accounting used to prepare federal grant reports. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

(2) Subrecipients

Of the federal expenditures presented in this schedule, the Department provided federal awards to subrecipients as follows:

<u>Program Title</u>	<u>CFDA Number</u>	<u>Amount Provided to Subrecipients</u>
Coastal Zone Management Administration Awards:		
Hawaii Coastal Zone Management Program	11.419	\$ 1,272,472
State Energy Program:		
Formula Grant	81.041	90,213

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Schedule of Findings and Questioned Costs

Year ended June 30, 2002

(1) Summary of Auditors' Results

- (a) The type of report issued on the basic financial statements: **Unqualified opinion**
- (b) Reportable conditions in internal control were disclosed by the audit of the basic financial statements: **Yes**
Material weaknesses: **None noted**
- (c) Noncompliance which is material to the basic financial statements: **None noted**
- (d) Reportable conditions in internal control over major programs: **Yes**
Material weaknesses: **None noted**
- (e) The type of report issued on compliance for major programs: **Unqualified opinion**
- (f) Any audit findings which are required to be reported under Section .510(a) of OMB Circular A-133: **Yes**
- (g) Major programs:

Research and Development Cluster:

Department of Defense:

12.910 – National Defense Center of Excellence for Research in Ocean Sciences

12.910 – Hawaii Electric Vehicle Demonstration Project

Department of Transportation:

DTRS56-99-T-0017– Hawaii Electric Vehicle Demonstration Project

- (h) Dollar threshold used to distinguish between Type A and Type B programs: **\$322,000**
- (i) Auditee qualified as a low-risk auditee under Section .530 of OMB Circular A-133: **No**

(2) Findings Relating to the Basic Financial Statements Reported in Accordance with *Government Auditing Standards*

Finding 02-01 Administration of Loan Programs

Criteria: A well-functioning loan program requires adequate monitoring of outstanding loans and adherence to loan administration policies and procedures, including maintenance of loan files and depositing loan repayments.

Condition: During our review of the loan administration process, we noted that the Department could improve the monitoring of outstanding loans, documentation of loan administration guidelines, maintenance of loan files, and depositing of loan repayments.

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ECONOMIC DEVELOPMENT, AND TOURISM**

STATE OF HAWAII

Schedule of Findings and Questioned Costs

Year ended June 30, 2002

Monitoring Outstanding Loans

The Department's policies and procedures for monitoring outstanding loans and identifying past due accounts could be improved. The Department does not follow-up with delinquent borrowers in a timely manner. In addition, the Department has not monitored its delinquent participation loans with other financial institutions.

At June 30, 2002, the Department had 94 outstanding loans with an aggregate principal balance of \$9,449,566. Of these loans, 45 loans with an aggregate principal balance of \$5,568,059 were greater than 90 days past due. Loan amounts written-off by the Department in fiscal year 2001-2002 and fiscal year 2000-2001 amounted to \$281,418 and \$734,966, respectively.

The following table illustrates the total number of loans greater than 90 days past due, the total principal amount of loans greater than 90 days past due, and the total amount of loans written off during the previous three fiscal years:

	Fiscal year 2001-2002	Fiscal year 2000-2001	Fiscal year 1999-2000
Number of loans outstanding at June 30	94	96	106
Number of loans with balances greater than 90 days past due at June 30	45	49	53
Percent greater than 90 days past due at June 30	48%	51%	50%
Amount of loans outstanding at June 30	\$ 9,449,566	\$ 9,971,277	\$ 12,107,292
Amount of loans with balances greater than 90 days past due at June 30	\$ 5,568,059	\$ 5,931,910	\$ 6,611,252
Percent greater than 90 days past due at June 30	59%	59%	55%
Number of loans written off as of June 30	6	4	5
Amount of loans written off as of June 30	\$ 281,418	\$ 734,966	\$ 6,824

To assist in monitoring delinquent loans, the Department generates a *Contractual Delinquency Report* on a monthly basis and a *Non-Tax Revenue Collection Report – Accounts Over 60 Days Report* on a quarterly basis. Both reports are reviewed by the Department and used to identify and monitor delinquent borrowers. We noted that these reports were not generated on a timely basis, and as a result, the Department has been unable to identify delinquent accounts until after they were 30 days past due. Waiting until an account is 30 days past due does not enable the Department to work proactively with delinquent borrowers to develop an effective repayment plan. In comparison, financial institutions generate delinquency reports on a daily basis and contact delinquent borrowers the moment the loan becomes past due.

**DEPARTMENT OF BUSINESS,
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STATE OF HAWAII

Schedule of Findings and Questioned Costs

Year ended June 30, 2002

We also noted that the Department does not actively monitor its delinquent participation loans. Participation loans are loans in which the Department assists other financial institutions (lead bank) in providing funds to borrowers. For these types of loans, the Department's policy is to contact the lead bank once an account is more than 30 days past due. However, we were informed that no subsequent correspondence is made to ensure that the lead bank is adequately monitoring the delinquent borrower. Because the Department has not been actively working with the various lead banks, the Department is unable to determine the sufficiency of the collection efforts made.

Documentation of Loan Administration Guidelines

Although the Department has policies and procedures in place over the administration of its various loan programs, these policies and procedures are not formally documented. The Department lacks written guidelines over loan origination, maintenance of loan files, loan payment processing, and monitoring of delinquent borrowers. This has resulted in inconsistencies in the Department's maintenance of loan files and the processing of loan repayments. Formally documenting and enforcing established policies and procedures is necessary to ensure that loans are approved and serviced consistently and in accordance with departmental guidelines.

Maintenance of Loan Files

Loan files contain vital documentation for each loan and should provide evidence that the Department's policies and procedures are followed. Our review of selected loan files revealed that the Department's loan files did not contain adequate documentation of on-site inspections of applicant's collateral and evidence that loan proceeds were spent for authorized purposes.

Department policy requires performance of an on-site inspection of the applicant's collateral by a business loan officer, prior to formal approval of a loan. However, documentation of this on-site inspection is not consistently maintained in the loan file. We were unable to locate documentation of on-site inspections for any of the 28 loan files we reviewed and, as a result, were unable to verify that required on-site inspections were properly performed. This could result in inadequate security on loans outstanding.

All borrowers are required to provide evidence to the Department that loan proceeds are spent for authorized purposes. While performing procedures to ensure that the Department complied with this requirement, we noted that 8 out of a sample of 24 borrowers did not submit receipts and/or supporting documentation to the Department evidencing proper use of loan proceeds. As a result, for these 8 borrowers, we were unable to verify that loan proceeds were spent for authorized purposes. The original amount of the 8 loans aggregated to \$1,206,000.

The Department has a standardized checklist of all required loan file documentation to assist in assuring that all necessary documents are obtained and filed. However, we noted that the Department has not consistently utilized this checklist to ensure proper file maintenance.

**DEPARTMENT OF BUSINESS,
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STATE OF HAWAII**

Schedule of Findings and Questioned Costs

Year ended June 30, 2002

Depositing Loan Repayments

We noted that the Department was not processing and depositing loan repayment receipts in a consistent and timely manner. Checks received by the Department for loan repayments should be deposited on the day of receipt. Delays in depositing loan repayment checks result in lost interest earnings to the Department and increase the possibility of checks being lost or misappropriated.

Out of a sample of 15 loan repayment checks, we noted 12 that were not deposited by the Department on a timely basis. These 12 checks totaled \$226,171 and the average number of business days elapsing between receipt of the checks and time of deposit was six business days. Checks amounting to \$83,325 and \$29,500 were deposited six and nine business days, respectively, after they were received.

Effect: Without policies and procedures to monitor delinquent accounts in a timely and effective manner, collection efforts will be hampered. In addition, the lack of written guidelines and the inability to enforce internal policies and procedures covering various aspects of loan administration has resulted in inconsistencies in the maintenance of loan files and processing of loan repayments.

Recommendation: We recommend that the Department:

- Revise procedures to monitor delinquent borrowers by following up on delinquent accounts the moment they become past due (e.g., contact the borrower when an account becomes ten days past due). For participation loans, the Department should coordinate collection efforts with lead financial institutions to ensure collection of past due amounts.
- Formally document the Department's policies and procedures over the following loan functions: loan origination, maintenance of loan files, loan payment processing, and monitoring of delinquent borrowers.
- Ensure that loan files are properly maintained and contain all required documentation. The Department's standardized checklist of all required loan file documentation should be consistently utilized to ensure proper file maintenance.
- Deposit loan repayments on the day of receipt.

Finding 02-02 Hawaii Tourism Authority Contract Management

Criteria: State procurement rules require that a contract be executed before any services are performed by contractors. The Hawaii Tourism Authority (Authority) requires all of its contractors, upon completion of each contract, to complete and submit a final report to enable the Authority to evaluate contractor performance and required deliverables.

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Year ended June 30, 2002

Condition: The majority of the functions carried out by the Authority are performed by third-party contractors. The Authority's contractors assist in coordinating events to be held in Hawaii and assist in marketing and promoting Hawaii as a vacation and business destination. During the fiscal year ended June 30, 2002, the Authority incurred approximately \$69.4 million in contract expenditures, which accounted for over 98% of its total expenditures.

Upon completion of each contract, contractors hired by the Authority are required to complete and submit a final report documenting the scope of the work performed, costs incurred, reasons for any deviations from the terms and conditions of the contract, the anticipated benefits, areas for which improvement is needed, and any other additional comments and/or suggestions noted while performing the contracted service. All final reports are reviewed and approved by the Authority to ensure that services were performed in accordance with the terms of the contract and to determine whether the Authority should continue to do business with the respective contractor. The Authority's policy is to withhold final payment until a final report is received from the contractor and approved by the Authority.

During our review of the Authority's contract management process, we noted several instances where (1) services were performed by contractors prior to the execution of legally binding contracts; (2) final reports from contractors were not received in a timely manner; (3) contracts were renewed with contractors prior to the Authority's evaluation of the quality of the work provided; and (4) in one instance, final payment was remitted to the contractor prior to the contractor completing all required tasks.

We selected 16 contracts for testwork. Such contracts accounted for more than 70% of the Authority's current year's contract expenditures. During our testwork, we noted:

- Three instances where contractors commenced work prior to the execution of legally binding contracts. The total amount of these contracts was \$233,000 and services were performed by contractors as much as 8 months prior to the formal execution of a contract.
- Three instances where final reports were received and approved after the deadline specified in the contract agreement. The total amount of these contracts was \$475,000. The final reports were received by the Authority as much as 11 months after the deadline specified in the contract.
- Two instances where contracts were renewed with contractors prior to the receipt and approval of the final reports. The total amount of these contracts was \$150,000. The contracts were renewed as much as 7 months prior to the receipt of the final reports.
- One instance where payment was remitted to a contractor prior to the receipt and approval of the final report. The total amount of the contract was \$100,000 and the final payment was \$40,000. The final payment was made approximately 1 month before the Authority approved the final report. We were informed by the Authority that although the check for the final payment was generated prior to the receipt of the final report, the Authority did not remit the check to the contractor until after the final report was properly received and approved.

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Schedule of Findings and Questioned Costs

Year ended June 30, 2002

Effect: A properly executed contract is essential to ensuring that the type and scope of services agreed upon and the roles and responsibilities of both the Authority and its contractors are clearly delineated to avoid confusion or misunderstanding. Contracts should be properly executed before any services are rendered to the Authority. Without the benefit of a contract, there is no assurance that services being provided are those that are required.

Given the magnitude of service contracts and the Authority's limited resources, it is imperative that the Authority monitor contractors and relevant agreement terms in a complete and timely manner. This includes the evaluation of contractor performance and required deliverables prior to final payment and contract renewals, as well as ensuring that final reports are received from contractors by the completion date stipulated in the contract.

Recommendation: We recommend that the Authority execute formal contracts before services are performed by contractors. We also recommend that the Authority monitor its contracts and relevant agreement terms in a complete and timely manner. Final reports should be received from the contractors by the completion date stipulated in the contract. Further, final payments should be withheld from contractors until the final reports are received from contractors and approved by the Authority. A final evaluation of each contractor should be performed prior to entering into any subsequent agreements with them.

Finding 02-03 Encumbrances

Criteria: To budget and allocate state funds properly, the Legislature requires an accurate accounting of available funds. All outstanding encumbrances that relate to projects or purposes that have been closed, terminated, and/or completed should be promptly unencumbered and unspent funds should be made available for other state purposes.

Condition: We noted numerous encumbrances outstanding at June 30, 2002 related to inactive contracts and purchase orders. We noted 11 instances out of a sample of 30 where funds were encumbered for contracts or purchase orders that were cancelled, inactive, and/or expired. Of the 11 instances, 8 related to encumbrances that should have been voided at least two fiscal years ago, with 1 encumbrance that should have been voided in 1994. These 8 encumbrances ranged from \$7,282 to \$190,000 and totaled \$517,430.

Department personnel indicated that invalid encumbrances exist because the division that originated the contract/purchase order did not inform the fiscal office that the contract/purchase order was no longer active and that no further payments are expected.

The Department does not have a formal process to ensure the validity of fiscal year-end encumbrances. Department personnel informed us that they do not annually review outstanding encumbrances to verify that all encumbered amounts are for valid future expenditures. Department personnel also informed us that they do not investigate old encumbrances to ensure that encumbered amounts relate only to active projects. As a result, numerous unspent balances remained encumbered despite the fact that the contract/purchase order that they relate to are no longer active. Based on an evaluation of all encumbrances outstanding at June 30, 2002 greater than five years old, we identified 40 encumbrances totaling \$879,385 (\$312,640 in

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Schedule of Findings and Questioned Costs

Year ended June 30, 2002

the Bond Fund, \$538,929 in the General Fund, and \$27,816 in the Special Revenue Fund) that related to commitments that were cancelled, terminated, and/or completed.

Effect: By not lapsing old, unnecessary encumbrances, funds are not available to other programs and departments for valid purposes.

Recommendation: We recommend that the Department adhere to established policies and procedures to unencumber funds relating to contracts/purchase orders that are fulfilled during the year. The Department should also periodically evaluate the propriety of all outstanding encumbrances to ensure that all encumbrances correspond to active and ongoing projects or purposes.

Finding 02-04 Petty Cash

Criteria: Per the Hawaii Administrative Rules section 3-11-11, "Each agency is responsible for instituting procedures of internal control that will assure proper maintenance of its petty cash funds. The internal control procedures shall include as appropriate, periodic unannounced cash counts, independent bank account reconciliations, and regular reviews that would disclose disbursements for personal loans or other unauthorized items. Mere approval of warrant vouchers for replenishments does not constitute adequate internal controls."

Condition: While performing our procedures over the Department's petty cash, we noted that the Department lacks adequate segregation of duties over petty cash functions. At the Department's various divisions, we observed that the petty cash custodian performs both the custodial and reconciliation functions. The custodial and reconciliation functions should be separated and performed by different individuals to minimize the risk of misappropriation of petty cash funds.

We also noted that the Department's various divisions did not submit account reconciliations to the fiscal office in a timely and consistent manner as required by Department policy. Upon each replenishment request, all divisions must submit to the fiscal office a reconciliation of their petty cash fund. However, Department personnel informed us that the fiscal office has not been enforcing this requirement. As a result, we noted 7 reimbursement requests out of a sample of 15 that were received and processed by the fiscal office without a completed reconciliation of the respective division's petty cash account. At June 30, 2002, we noted an overage in the Foreign Trade Zone's petty cash account. All other petty cash balances were properly reconciled at June 30, 2002.

The Department maintains a balance of \$25,000 in its administration petty cash fund. During fiscal year ended June 30, 2002, the average monthly disbursement out of this account was \$356, with \$776 being the largest monthly disbursement. Replenishment requests are generally prepared monthly. The Department receives replenishments approximately five weeks after the request is submitted. Based on the account's minimal monthly disbursements and the frequency upon which the fund is replenished, the \$25,000 balance may be excessive. We noted that these excess funds do not earn interest.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Schedule of Findings and Questioned Costs

Year ended June 30, 2002

Effect: Inadequate segregation of duties over the petty cash function and untimely reconciliation of petty cash funds increases the risk of errors or misappropriation of petty cash funds. Maintaining excess petty cash funds prevents other programs from using these funds for valid purposes. Further, because the Department does not invest its petty cash funds in interest bearing accounts, the Department is unable to earn interest income on these funds.

Recommendation: We recommend that the Department:

- Perform periodic, unannounced reviews of each division's petty cash reconciliations including unannounced cash counts. An employee independent of the petty cash process should perform the review.
- Adhere to established policies requiring divisions to prepare and submit reconciliations of their petty cash account upon each request for replenishment. If reconciliations are not prepared and submitted, the fiscal office should not process the replenishment request.
- Consider reducing the amount of funds in its administration petty cash fund.

(3) Findings and Questioned Costs Relating to Federal Award

Research and Development Cluster

Department of Defense

National Defense Center of Excellence for Research in Ocean Sciences

Hawaii Electric Vehicle Demonstration Project

CFDA No. 12.910

Federal Award No. MDA972-97-2-0001 and MDA972-95-2-0009

Department of Transportation

Hawaii Electric Vehicle Demonstration Project

CFDA No. DTRS56-99-T-0017

Finding 02-05 Cash Management

Criteria: OMB Circular A-102, *Common Rule for Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments* (OMB Circular A-102) Section .21 states that, "Methods and procedures for payment shall minimize the time elapsing between the transfer of funds and disbursement by the grantee or subgrantee, in accordance with Treasury regulations at 31 CFR Part 205." In addition, the grant agreement for the National Defense Center of Excellence for Research in Ocean Sciences and the Hawaii Electric Vehicle Demonstration Project requires the Department to maintain funds in interest-bearing accounts. The grant agreements also specify that interest earned be remitted back to the federal granting agency if in excess of prescribed limits or be used to offset future advances.

**DEPARTMENT OF BUSINESS,
ECONOMIC DEVELOPMENT, AND TOURISM
STATE OF HAWAII**

Schedule of Findings and Questioned Costs
Year ended June 30, 2002

Condition: During our testwork on cash management, we noted that the Department received advanced funding from federal granting agencies. These funds were not deposited into interest-bearing accounts. We also noted that, during 2002, the National Defense Center of Excellence for Research in Ocean Sciences and the Hawaii Electric Vehicle Demonstration Project, had average month-end cash balances of approximately \$1,124,569 and \$934,841, respectively. We did note, however, that the Department requested funds within the prescribed limits of the respective grant agreements.

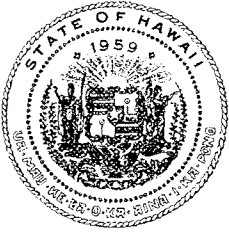
Effect: The Department did not earn interest on funds advanced from federal granting agencies. As a result, the Department was unable to offset program costs or remit excess interest earnings to federal granting agencies.

The Department is only allowed to request funds on approximately a bi-monthly basis for the National Defense Center of Excellence for Research in Ocean Sciences and as a result, the Department maintains sufficient funds to ensure that the programs are able to meet program needs. For the Department of Defense, Hawaii Electric Vehicle Demonstration Project program, funds were received in previous years and are currently being expended. We were also informed that the current policy with the State Department of Budget and Finance does not allow the Department to earn interest on federal funds.

Questioned Cost: While there are questioned costs associated with this finding, the Department is currently unable to estimate the exact amount of foregone interest. The National Defense Center of Excellence for Research in Ocean Sciences program has estimated and confirmed with the respective federal granting agency the cost of interest owed to the federal granting agency at \$250,000 for prior years. The Department is working with the respective federal granting agencies to resolve the amount owed for the current year.

The Hawaii Electric Vehicle Demonstration Project is currently unable to estimate the amount of forgone interest. The Department is working with the respective federal granting agencies to resolve this situation.

Recommendation: We recommend that the Department maintain federal funds in interest-bearing accounts. The Department should remit interest in excess of prescribed limits to the respective federal granting agencies or be used to offset future advances. We also recommend that the Department monitor its cash balances on a regular basis to minimize the time elapsing between the receipt and disbursement of funds from federal granting agencies.



DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT & TOURISM

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March 18, 2003

KPMG LLP
Pauahi Tower, Suite 2100
Honolulu, Hawaii 96813

Dear Auditors:

In response to the Finding and Questioned Cost Relating to Federal Awards for the Fiscal Year ended June 30, 2002, the following are the Department's comments:

Finding 02-05 Cash Management

Department of Defense
National Defense Center of Excellence for Research in Ocean Sciences (CEROS)

Program's Response:

The CEROS Program resumed maintaining federal funds in interest-bearing accounts as of February 1, 2002 after a cash management finding was issued in the audit of FY 2001. Prior to this, CEROS had discontinued investing its funds because the funds were often unavailable when they were needed to pay contractor's invoices. However, the CEROS Program has invested all grant funds in interest-bearing accounts by participation in the State's Treasury Investment Pool System. Under this system, interest earned is allocated monthly based on average daily cash balance of the agency's account and therefore, the investment of funds does not affect the timing of contract payments.

The CEROS Program has remitted the amount of interest earned from February to December 2002 to the federal granting agency in accordance with the grant agreement. In order to minimize the time elapsing between the transfer of funds and disbursement, the CEROS Program has requested advances only when cash balances are reasonably low. Although this has resulted in several instances where payments to contractors were delayed, the CEROS Program will continue to monitor its balances to maintain the minimum needed for disbursements.

Department of Defense
Department of Transportation
Hawaii Electric Vehicle Demonstration Project (HEVDP)

Program's Response:

The HEVDP Program began investing its grant funds in the State Treasury Investment Pool System after a cash management finding was issued in the audit for FY 2001. The interest on funds remaining under Cooperative Agreement MDA972-95-2-0009 is being remitted back to the Department of Defense. The remaining funds from Cooperative Agreement MDA972-95-2-0009 are soon to be fully expended.

The current funding for the HEVDP Program is coming from the Department of Transportation (DOT) under an Advance Vehicle Program (AVP) Other Transaction Agreement that does not follow OMB Circular A-102. The agreement follows procedures in which DOT transfers funds for contractor payments after project milestones are completed. The procedure minimizes the time elapsing between receipt and disbursement of funds, thus addresses the second recommendation of the auditor.

The DOT agreement provides for the advance funding of the project development fee that is equivalent to 5% of the agreement. The advance is used to cover program administrative expenses and provides a cushion of funds to cover payments to contractors while waiting for DOT funds to be wired as mentioned above. The advance for project development fees is being invested and the interest is to be used to cover costs of the HEVDP Program.

In response to the Findings related to the Basic Financial Statements for the Fiscal Year ended June 30, 2002, the following are the Department's comments:

Finding 02-01 Administration of Loan Programs

Program's Response:

We would like to point out that the Hawaii Capital Loan Program (HCLP) was established to serve businesses that are unable to obtain financing from conventional lending institutions. As such, the HCLP does not function in the same manner as a bank or financial institution. Accordingly, we feel criteria appropriate in reviewing an economic development loan program should be used in auditing the HCLP rather than measuring the program under the guidelines of federally regulated lending institutions.

Monitoring Outstanding Loans

The continued high rate of delinquency is due to loans which are deemed uncollectible, but which were not recommended for write-off on a timely basis by the Office of the Attorney General during the prior administration.

Although the department generates monthly Delinquency Reports, immediate follow up on delinquent loans could be achieved by better coordination between the Financial Support Branch and the Department's Accounting Section in providing access to loan receipt data on a daily basis.

The Deputy Attorney General working with the loan program on collections is immediately available if questions arise on loan documentation.

Loan collections on participation loans are done by the lead bank. Most lending institutions refer commercial loan collection to their specialized Loan Collection Departments. The collection department is versed in their collection techniques/activities and ensures that they are within guidelines established by the state as well as the federal government. They may not provide us with written collection activities on the account, but will verbally discuss important matters that they feel could have an effect on our participation loan. We feel that the participating lending institutions are capable of pursuing collection and ensuring that they adhere to our Participation Agreement in the proper service of our joint loans. Further, the participating financial institutions are working under federal guidelines to maintain a low delinquency ratio.

Documentation of Administration Guidelines

Our procedures require that all loan files contain a standardized "checklist" which was developed to ensure that all necessary documents are obtained and filed. We will strive to be consistent in using the checklist to ensure that all loan files contain the required documentation and are properly maintained.

We do not disagree that ideally within large bureaucracies there would be perfect documentation on all procedures. However, given the reality of short-handed staffing and a very small program to begin with, we feel it would not optimize taxpayer resources to prepare lengthy loan administration documentation for a program with one loan officer. The DBEDT's loan officers have always had extensive bank experience and are familiar with the procedures of loan authorization and documentation.

Maintenance of Loan Files

A mandatory site inspection is done of the business premises of all recipients of commercial loans, with the exception of recent loans made under the Hawaii Emergency Loan Program, which provided loan assistance to businesses affected by the tragedies of September 11. These exceptions were done to expedite our loan processing. Documentation of our loans will

indicate that collateral that is secured is a blanket security interest (UCC I) in accounts, accounts receivable, deposit, furniture, fixtures, equipment, etc., and possibly other real property. Therefore, should specific equipment be taken as collateral, the item is inspected and documented in the recordation of our security interest.

When available, the borrowers are required to provide the department with invoices showing that the loan proceeds were properly used. However, in some situations we are unable to specifically target the monies being spent when the purpose of the loan indicates that the proceeds are to be used for "working capital".

Deposit of Loan Repayments

Since July, 2002, the procedure to deposit loan repayment checks was revised to require that checks be deposited daily. The Department has been making every effort to deposit checks on a timely basis to improve the accounting function for the deposit of loan repayments.

Finding 02-02 Hawaii Tourism Authority Contract Management

Program's Response:

In the Single Audit Report for Fiscal Year 2002 presented by KPMG, LLP, it is stated that based on its review of a sampling of the Hawaii Tourism Authority's ("HTA") contracts, it discovered nine instances when (1) services were provided before a formal, written contract was executed; or, (2) contractors submitted a final report to the HTA either after the deadline provided in the contract, after the contract was renewed, or after final payment was made by the HTA.

The HTA acknowledges the auditor's findings and understands that its resulting recommendations to completely and timely adhere to the state's contract rules and processes are intended to improve our operations, and to ensure, through contractor compliance, that the state gets what it pays for while minimizing our liability.

As a state agency subject to governmental rules and procedures, we desire full compliance with the state's contracting processes and, following the recommendations of the 2002 Legislative Audit of the HTA, have made great strides over the last year in improving our internal contract managing procedures. However, we continue to maintain that it is equally important to balance that charge with our overall responsibility as the lead state tourism agency. We must continue to work with our partners in the public and private sectors to achieve the larger goal of a healthy and vibrant Hawaii tourism industry.

We recognize that there will be instances when we will be unable to fully comply with standard contracting practices as recommended by the auditor. For some programs, this non-compliance will be an ongoing issue. In other cases, extenuating circumstances on the part of the contractor or the state will result in non-compliance. However, if we are to further the development of Hawaii's visitor industry, if we are to work to ensure the continued successful implementation of the program or event itself, and if we are to support the long-term advancement of our local community-based organizations run by volunteers without full-time dedicated staff, we must allow for flexibility in the process to be compassionate, responsive, and accountable.

In addition, it is important to note that, from an accountability standpoint, the HTA staff works closely with the organizations to monitor the projects and ensure that the work is being carried out.

In summary, we understand the auditor's findings and recommendations and will continue to strive to comply. However, as noted above, there will be some instances when this will not be possible. We are taking steps to communicate with our contractors our intent to adhere to the complete terms of all our contracts and have contacted the State Office of the Auditor for a meeting to discuss ways in which we can improve our contracting process, in light of the structural issues we face. We recognize that our contractors are valuable associates in our efforts to achieve the HTA's goal of a healthy and vibrant Hawaii tourism industry, and the contributions that they make towards assisting the HTA in achieving its goal are important to both our industry and to our community.

Finding 02-03 Encumbrances

Department's Response:

The Department's Contracts Section has been working with the Departmental programs since November, 2002 to close out all of the inactive contracts. To date, we have closed out or are in the process of closing out 90% of these inactive contracts.

The Department will continue to work with its programs to ensure the timely closing of inactive contracts by providing a quarterly listing of all outstanding contracts nearing expiration to the programs for their determination as to whether a contract should be closed or extended. Non-responses or unreasonable extensions will be forwarded to the Administrative Services Officer for a final decision.

The Department has developed a contracts manual and has held detailed training sessions with the programs on contracts procedures. The Department will be adding detailed contracts closure procedures to supplement the contract manual including the web version of the manual for program staff. Additionally, classes will be held to further instruct the program staff responsible for contract monitoring and contracts closure procedures.

In addition, the Department's Fiscal Section will work with programs to ensure the timely closing of inactive encumbrances for purchase orders by performing a quarterly review of purchase orders and reducing encumbrance balances that are no longer required for obligations.

Finding 02-04 Petty Cash

Department's Response:

Since November, 2002, the Department has been enforcing compliance with established petty cash fund procedures by requiring programs submit a reconciliation of its petty cash fund total with each replenishment request. Also, the overage in the Foreign Trade Zone's petty cash fund has been corrected by the deposit of the overage amount to the State General Fund in accordance with the State's accounting policies.

A significant decrease in the volume of transactions processed from the administration petty cash fund has resulted primarily from the establishment of additional petty cash funds at the agency level. The Department has recently completed an evaluation of the current requirements for its administration petty cash fund and will be reducing its fund by returning the excess amount to the State general fund.

To improve the administration of petty cash funds, the Department will continue to require petty cash fund total reconciliations be submitted with each replenishment request, conduct periodic reviews of the petty cash fund account reconciliations including unannounced cash counts, and take steps to resolve any petty cash fund discrepancy with the program as soon as it is detected. In addition, the Department will be reissuing the regulations governing petty cash funds to affected programs and will monitor program compliance with established procedures.

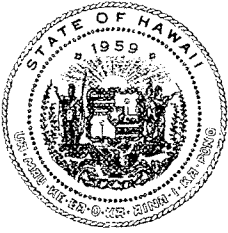
Thank you for the opportunity to provide comments on the audit report.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ken N. Kitamura', with a stylized, flowing script.

Ken N. Kitamura
Administrative Services Officer

KNK:wwy:lck



DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT & TOURISM

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March 18, 2003

KPMG LLP
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Dear Auditors:

The following is the status of the prior year's finding for the Fiscal Year ended June 30, 2001 relating to Cash Management:

Department of Defense
National Defense Center of Excellence for Research in Ocean Sciences (CEROS)

The CEROS Program has invested all grant funds in interest-bearing accounts after the cash management finding was issued in the audit report for FY 2001. Also, in accordance with the grant agreement, the amount of interest earned for the period from February to December 2002 has been remitted to the Department of Defense and the CEROS Program will continue to remit future interest income earned.

In order to minimize the time elapsing between the transfer of funds and disbursement, the CEROS Program has requested advances only when cash balances are reasonably low.

Department of Defense
Department of Transportation
Hawaii Electric Vehicle Demonstration Project (HEVDP)

The HEVDP Program has invested all grant funds in interest-bearing accounts after the cash management finding was issued in the audit report for FY 2001. In addition, the interest on funds remaining under Cooperative Agreement MDA972-95-2-0009 will be remitted back to the Department of Defense.

KPMG

March 18, 2003

Page 2

The current funding for the HEVDP Program is received from the Department of Transportation (DOT) under an Advance Vehicle Program (AVP) Other Transaction Agreement that does not follow OMB Circular A-102. The agreement follows procedures in which DOT transfers funds for contractor payments after project milestones are completed. Accordingly, this current procedure followed minimizes the time elapsing between receipt and the disbursement of funds.

The DOT agreement also provides for the advance funding of the project development fee that is equivalent to 5% of the agreement which is used to cover program administrative expenses and provide a cushion of funds to cover payments to contractors while waiting for DOT funds to be wired. The advance for project development fees is being invested and the interest is being used to cover costs of the HEVDP Program in accordance with the agreement.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ken N. Kitamura', with a stylized flourish extending to the right.

Ken N. Kitamura
Administrative Services Officer

KNK:wwy